Commercial/Industrial Real Estate Loan Review

Consider the following procedures at each examination. Examiners are encouraged to exclude items deemed unnecessary. This procedural analysis does not represent every possible action to be taken during an examination. The references are not intended to be all-inclusive and additional guidance may exist. Many of these procedures will address more than one of the Standards and Associated Risks. For the examination process to be successful, examiners must maintain open communication with bank management and discuss relevant concerns as they arise.

IMPORTANT
This module is intended for those extensions of credit secured by liens on or interests in income producing properties.

POLICY CONSIDERATIONS

1 Within the context of the bank's size and complexity, determine the adequacy of the commercial and industrial real estate lending policy. Determine if policies appropriately address the following areas:

1 A The bank's target market and circumstances under which the bank may extend commercial real estate credits on properties located outside this market.

1 B Maximum loan amount, loan maturity, amortization schedule, and pricing structure for each type of real estate loan.

1 C LTV limits in accordance with the Real Estate Lending Standards (FDIC's Rules and Regulation Part 365, FRB: Regulation H Subpart C.) (Note: It is important to distinguish between the regulation and the interagency guidelines. While the guidelines are included as an appendix to the regulation, they are not part of the regulation.)

1 D Guidelines for minimum debt service coverage ratios.

1 E Consideration of the overall creditworthiness of the borrower.

1 F The level of the borrower's equity invested in the property.

1 G Any secondary sources of repayment.

1 H Any additional collateral or credit enhancements, such as guarantees, mortgage insurance, or takeout commitments.

1 I Lending with partial or no recourse to the borrower.

1 J Guidelines for initiating foreclosure actions. (Refer to Other Assets and Liabilities module.)

1 K ALLL guidelines that address impaired real estate values and ALLL adequacy.

2 Determine if the appraisal and evaluation policy includes appropriate guidance for collateral valuation.

2 A Determine if all commercial real estate transactions of $250,000 or more contain appraisals performed by a certified appraiser. (FDIC: Rules and Regulations - Appraisals. FRB: Regulation H - Appraisals.) (Note: Any transaction not requiring the service of a certified appraiser must still be supported by a collateral valuation that is consistent with safe and sound banking practices.)

2 B If an appraisal was not required or obtained, review management's procedures for valuing collateral. Determine if assumptions are reasonable.

2 C Review the adequacy of management's guidelines that describe when collateral reassessments are necessary (for example, prior to restructuring or refinancing the credit, or when problems with the primary source of repayment arise). Be sure to consider compliance with state law for collateral revaluation.

ADMINISTRATION

3 Review the bank's underwriting practices. The following situations may indicate liberal underwriting practices:

3 A Inadequate credit or collateral documentation.

3 B Additional risk from real estate collateral located in unfamiliar or distant market areas.

3 C Loan terms, such as interest rates, limited recourse to the borrower, and LTV requirements that appear to be based on competitive factors and not underlying credit risk.

3 D No, or minimal, borrower equity.

3 E Real estate collateral values that have been driven up by rapid turnover of ownership without any corresponding improvements to the property or supportable income projections to justify the increased values (such as land flips). (Note: Uniform Standards of Professional Appraisal Practice (USPAP) require a discussion of the property's recent sales history.)

3 F Additional advances to service an existing loan without evidence that the entire loan will be repaid in full.

3 G Renewals, extensions, and refinancings that lack credible support for full repayment from reliable sources and do not have a reasonable repayment schedule.

3 H Speculative loans made with repayment dependent upon appreciation in the real estate collateral.

4 Determine if real estate taxes are current.

DOCUMENTATION

5 Review the loan file to determine if all necessary documentation is included and accurately completed.

5 A The following loan documents should be in the file:
1. Recorded mortgage (or deed of trust).
2. Recorded note.
3. Attorney's title opinion or title insurance.
4. Appraisal or collateral evaluation.
5. Evidence of appropriate insurance (property, liability, flood).
6. Assignments of leases.
7. Copies of leases (if not included as part of the appraisal).

5 B The following documents should generally be considered as part the credit analysis.
1. Loan presentation or approval memorandum.

2. Commitment letter (the final signed version).
3. Settlement sheet.
4. Current operating statements of the project.
5. Bank prepared "spreadsheets" or analysis.
6. Rent rolls.
7. Financial statements of other repayment sources.
8. Tax returns.
9. Loan officer's comment sheets.
10. Correspondence.
11. Guarantees (identify extent of guarantor liability).

CREDIT ANALYSIS

6 Review real estate market analyses for localities where the bank finances commercial real estate.

6 A Determine if management is aware of current market conditions and appropriately responding to changes. The following indicators or references are useful in evaluating the conditions of the real estate markets:

6 A1 1. Permits for new construction.
2. Estimated absorption periods.
3. Employment trends.
4. Vacancy rates.
5. Tenant lease incentives.
6. The level and trend in rental rates.
7. Internal resources (for example, Agency newsletters and publications).

7 Determine if repayment sources involve any intercompany borrower transactions.

8 Consider comparing rent rolls to rental income reflected in tax returns.

9 Determine if difficulties or weaknesses exist in individual commercial real estate projects.

9 A The following situations may indicate potential problems:

9 A1 1. Loan arrearages.
2. Tax arrearages.
3. Loans secured by junior liens.
4. Protracted amortization programs or maturity dates.
5. Excessive supply of similar projects in the same trade area.
6. Lack of a sound feasibility study or analysis.
7. Concept or plan changes (for example, a condominium project converted to an apartment project because of unfavorable market conditions).
8. Projects financed at the peak of the real estate cycle.
9. Projects refinanced for non-project related purposes.
10. Rent concessions resulting in cash flow below the level projected in the original feasibility study, appraisal, or evaluation.
11. Special purpose properties (for example, bowling alleys and full service car washes) that are not supporting debt service or providing a reasonable rate of return to the owner.
12. Concessions on finishing tenant space, moving expenses, and lease buyouts.
13. Slow leasing, lack of sustained sales activity, and increasing sales cancellations may reduce the project's income potential, resulting in protracted repayment or default.
14. Purchase money financing based on market values of collateral that are significantly higher than the actual purchase prices.

15. Land values that assume future rezoning.
16. Borrowers inexperienced in managing the type of property financed.
17. Environmental hazards.

10 Determine the credit quality of sampled loans.

10 A Evaluate the cash flow potential of the underlying collateral to repay the loan within a reasonable amortization period.

10 B Evaluate the borrower's willingness and ability to repay the loan from other resources, if necessary, and according to existing loan terms.

10 C Consider present and past performance on the credit relative to contractual terms.

10 D Consider the prospects for support from any financially responsible guarantors, with emphasis on excess liquidity, cash flow, and demonstrated willingness to honor guaranty agreements. (Note: The primary basis for the review and classification of the loan should be the original source of repayment and the borrower's intent and ability to fulfill the obligation without relying on third-party guarantees; however, the examiner should also consider the support provided by any guarantees when determining the appropriate classification.)

11 Review the underlying real estate collateral. (Note: As the borrower's ability and willingness to repay a loan decreases, the importance of the collateral value increases. The depth of an appraisal review depends on many factors, such as loan performance, appraisal date, and market conditions. Therefore, depending on the circumstances, the following points may not be relevant.)

11 A When a formal appraisal is required, consider the following items:

11 A1 1. A thorough market analysis section generally indicates that the overall quality of the appraisal is acceptable.
2. The most reliable sales comparisons are those that require only modest adjustments.
3. When the direct capitalization approach to value is used, the operating statement in the appraisal should be comparable to the actual operating results.
4. The appraiser's reconciliation of the three approaches to value should be reasonable. Any significant variation among approaches should be adequately explained.

12 Assess the reasonableness of the facts and assumptions used in the most recent appraisal or evaluation. (Note: Assumptions should be given a reasonable amount of deference. Examiners should not challenge the underlying assumptions that differ only in a limited way from what would normally be associated with the type, condition, and location of the property under review.)

12 A If material deviations from facts or assumptions are determined, adjust the estimated value of the property, if reasonably possible and supportable, for the purpose of the credit analysis. (Note: Adjustments to collateral value made for credit analysis purposes should not be based on worst case scenarios that are unlikely to occur.)

12 B Consider the following items as part of the assessment.

12 B1 1. Current and projected vacancy and absorption rates.
2. Lease renewal trends and anticipated rates.
3. Volume and trend in past due leases.
4. Feasibility study and market survey (to determine support for the assumptions concerning future supply and demand factors).
5. Rental rates or sales prices (taking into account all concessions).

6. Operating expenses (amounts and categories).
7. Deferred maintenance.
8. Net operating income of the property as compared with projections.
9. Discount and capitalization rates.
10. Marketing period estimated to achieve appraised value.
11. Conclusions.

13 Determine appropriate classification. (Notes: As a general principle, a performing real estate loan should not be automatically classified or charged off solely because the value of the underlying collateral has declined to an amount that is less than the loan amount. Conversely, the fact that the underlying collateral value equals or exceeds the current loan balance, or that the loan is performing as agreed, does not preclude the loan from classification if well-defined weaknesses jeopardize the repayment ability of the borrower. The evaluation of each credit should be based upon the fundamental characteristics affecting the collectibility of the particular credit.)

13 A When determining the appropriate classification of troubled commercial real estate loans when there are no other available and viable repayment sources other than the collateral, remember the definitions of Substandard, Doubtful, and Loss are different.

13 A1 1. SUBSTANDARD: Any such troubled real estate loan, or portion thereof, should be classified Substandard when well-defined weaknesses are present that jeopardize the orderly liquidation of the debt. Well-defined weaknesses include a project's lack of marketability, inadequate cash flow or collateral support, failure to complete construction on time, or the project's failure to fulfill economic expectations. They are characterized by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected.

13 A2 2. DOUBTFUL: Doubtful classifications have all the weaknesses inherent in those classified Substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently known facts, conditions and values, highly questionable and improbable. A Doubtful classification may be appropriate in cases where significant risk exposures are perceived, but loss cannot be determined because of specific reasonable pending factors that may strengthen the credit in the near term. Examiners should attempt to identify loss in the credit where possible thereby limiting the excessive use of the Doubtful classification.

13 A3 3. LOSS: Advances in excess of calculated current fair value, which are considered uncollectible and do not warrant continuance as bankable assets. There is little or no prospect for near term improvement and no realistic strengthening action of significance pending.